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# Investment Section

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for Fiscal Year ending June 30, 2010

## **REPORT ON INVESTMENT ACTIVITY**

This report is prepared by the Investment staff of the  
Kentucky Teachers' Retirement System.

**Mr. Paul L. Yancey, CFA**  
Chief Investment Officer

**Mr. Philip L. Webb**  
Director of Investment Accounting

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## **INVESTMENT COMMITTEE**

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*Executive Secretary*

**Mr. Paul L. Yancey, CFA**  
*Chief Investment Officer*



An Aon Company

December 1, 2010

**To the members of the Board of Trustees and participants of the Teachers' Retirement System of Kentucky:**

The financial markets produced solid returns in the fiscal year ended June 30, 2010 as the frightening downward spiral of financial crisis and severe recession was arrested. Markets rebounded as economic growth resumed in the second half of 2009. It soon became clear, however, that the effects of the financial crisis - and the excesses that led to it - would be long-lasting. At the end of the fiscal year, a still-distressed housing market, an overleveraged consumer sector, and fiscal problems at all levels of government seemed to portend a long, slow recovery with unemployment remaining abnormally high. With the solvency of some European governments coming into question in the spring of 2010, even the stability of the global financial system remained in doubt.

Still-dislocated financial markets afforded exceptional opportunities, which the System actively sought to take advantage of. For the first time, the System invested in high yield bonds, with an allocation of \$225 million, due to extraordinary value in that sector. A total commitment of \$120 million was made to two fund managers participating in the U.S. Treasury's Public-Private Investment Program (PPIP) to take advantage of dislocations in the residential and commercial mortgage-backed securities markets. Both the high yield bonds and PPIP commitments were approved by the Board of Trustees as "additional categories" of investments as required by administrative regulation. A total of \$185 million in private equity commitments were made during the fiscal year, with the focus generally being one of capitalizing on unusual opportunities in specific sectors.

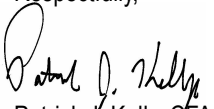
The System's portfolio returned 13.1% in the fiscal year, matching the return of the benchmark Policy Index. Domestic equities returned 15.1% versus 15.6% for the S&P 1500 Index. International equities returned 12.5% versus 10.9% for the MSCI All Country World (ex-U.S.) Index. Fixed income returned 11.7% versus 9.7% for the Barclays Government/Credit Index. Alternative strategies, including the opportunistic investments mentioned above, are expected to make a more significant contribution to total return in future years.

An expanded Investment Committee, including two outside experts, improved the decision-making process during the fiscal year. In legislative developments, House Bill 540 was passed by the Kentucky General Assembly, which ended the practice of diverting pension contributions to fund the Medical Insurance Fund and established a plan to, over time, pre-fund those benefits.

The System's investment program has always been based on fundamental value, a long-term focus on funding obligations to its members, and risk control. This philosophy led to a successful navigation of the financial turmoil of recent years. Continued adherence to these principles will help the System to meet its goals through whatever challenges and opportunities lie ahead.

It is a privilege to work with the System's investment staff, Investment Committee, and Board of Trustees. We look forward to continuing to help the System meet its long-term goals.

Respectfully,

  
Patrick J. Kelly, CFA  
Principal

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## INVESTMENT POLICY SUMMARY

The KTRS Board of Trustees has a statutory obligation to invest the members' assets in a manner consistent with the fiduciary standards set forth in the "prudent person rule." Consistent with these fiduciary standards, the board has recognized certain principles that guide investment-related decisions. First, the board will preserve the long-term corpus of the fund. Second, the board will seek to maximize total investment return within prudent risk parameters. Third, the board will act in the exclusive interest of the members and beneficiaries of the System. This broad summary is a reference point for management of System assets and outlines the investment philosophy and practice of KTRS.

## INVESTMENT OBJECTIVES

KTRS invests the members' funds in several diverse classes of assets, including equities, bonds and real estate. This diversification helps us earn the highest possible long-term rate of return within appropriate risk levels. In turn this enables us to pay guaranteed benefits to members and their beneficiaries at the lowest possible cost to participating employers and the taxpayers that fund them. Generally, the System's liabilities will not be paid for as many as 30-40 years. Therefore, as a long-term investor, KTRS holdings can withstand some short-term volatility. The System's long-term investment objective is to achieve an annualized rate of return of 7.5%.

## RISK CONTROLS

The KTRS investment program faces various risks; however, the primary risk to KTRS is that the assets will not support liabilities over long periods of time. In order to control this risk and any other risks, the board has taken the following steps on an ongoing basis:

- Actuarial valuations are performed each year to evaluate the funding objectives of the System. In addition, every ten years an external audit of the actuary is conducted to ensure that the assumptions made and calculation methods used are resulting in properly computed liabilities of the System.
- Asset/liability studies are conducted approximately every five years. These studies ensure that the portfolio design is structured to meet the liabilities of the System.
- The KTRS Investment Committee adopts, and regularly reviews, detailed investment strategies for implementation of the investment policy.

## ASSET ALLOCATION

Operating within relevant regulatory limitations, the System's investment consultant, on an annual basis, presents to the Investment Committee for approval target percentages and ranges for the System's various asset classes. Annually approved asset allocation parameters serve to balance the System's liquidity requirements, volatility tolerance, and return requirements to meet both short-term and long-term obligations. The System's assets are diversified across a variety of asset classes, investment management styles, and individual securities in order to reduce volatility and enhance the potential of the investment portfolio to achieve the System's long-term goals.

Asset allocation decisions for pension plans are highly dependent on the unique characteristics of a particular plan. Factors such as liability requirements, the level of funding, and statutory investment restrictions are important considerations within the context of the asset allocation decision making process. Consequently, asset allocations may differ markedly between various pension plans due to their unique circumstances.

The information below shows the System's asset allocation by market value as of June 30, 2010, and June 30, 2009, as well as the target and strategic range for each asset class for fiscal year 2010.

	<u><b>June 30, 2010</b></u>	<u><b>%</b></u>	<u><b>June 30, 2009</b></u>	<u><b>%</b></u>
Cash Equivalents *	\$ 218,429,317	1.7	\$ 134,219,594	1.1
Fixed Income **	3,933,016,478***	31.1	3,865,135,688	33.1
Domestic Equities	5,872,001,227	46.3	5,784,174,002	49.4
International Equities	1,703,159,180	13.4	1,344,393,598	11.3
Real Estate	419,613,671	3.3	425,746,050	3.6
Private Equity	110,757,811	0.9	60,731,073	0.5
Timberland	108,582,209	0.8	116,599,371	1.0
Additional Categories	<u>312,947,084</u>	<u>2.5</u>	<u>-0-</u>	<u>0.0</u>
Totals	<u><u>\$12,678,506,977</u></u>	<u><u>100.0</u></u>	<u><u>\$11,730,999,376</u></u>	<u><u>100.0</u></u>

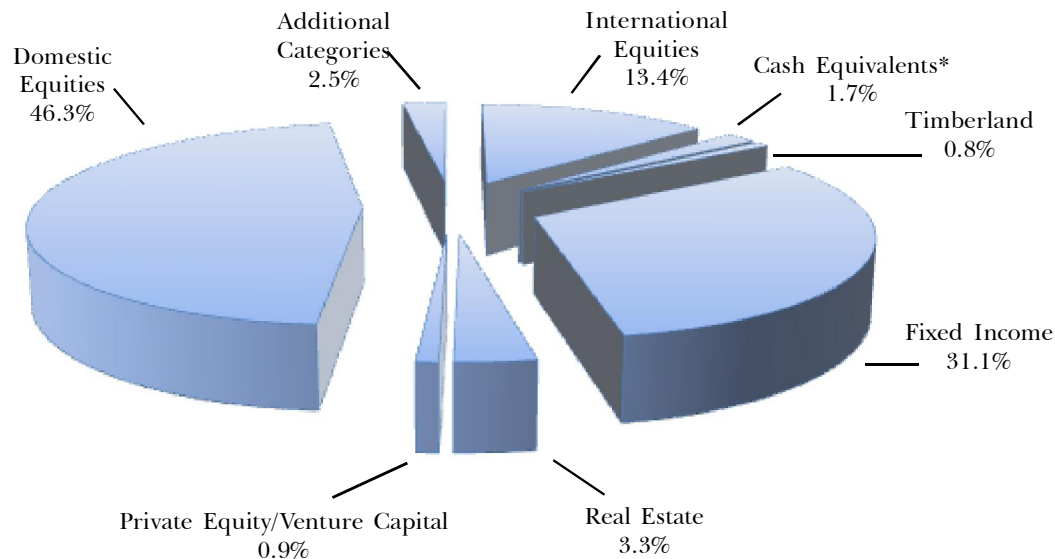
\* Reflects only cash balances not allocated to other asset classes. Uninvested cash balances allocated to various asset classes are represented in the respective asset classes.

\*\* Excludes purchased interest of \$1,450,327 as of June 30, 2010. Also, excludes purchased interest of \$1,060,537 as of June 30, 2009.

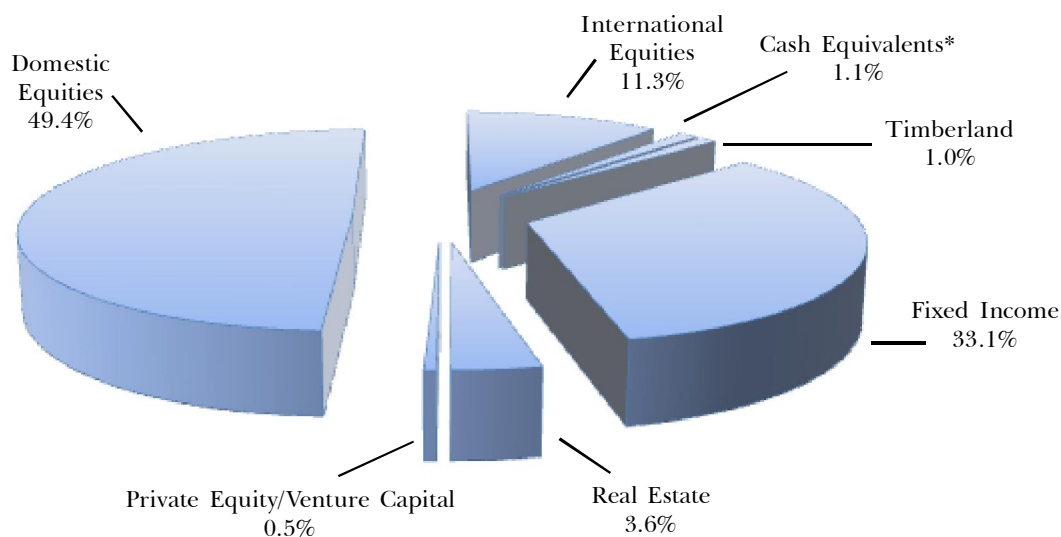
\*\*\* As of June 30, 2010, the Scholarship Fund is no longer reported in the pension fund Investment portfolio. The value of this fund at June 30, 2010 was \$482,153.

**Distribution of Investments  
Market Values**

**June 30, 2010**



**June 30, 2009**



\* Reflects only cash balances not allocated to other asset classes. Uninvested cash balances allocated to various asset classes are represented in the respective asset classes.

Strategic Weightings by Asset Class				
Asset Class	Regulatory Limits (Mkt Value)	Strategic Range (Mkt)	Target (Mkt)	6/30/2010 (Mkt)
Cash		1 - 3%	2.0%	1.7%
Fixed Income		25 - 32	28.0	31.1
Government/Agency/Other	Unlimited			17.4
Corporate	35%			13.7
Equity	65%	55 - 63	62.0	59.7
Domestic Large Cap		37 - 43	40.0	39.2
Domestic Mid Cap		3 - 6	5.0	4.4
Domestic Small Cap		2 - 4	3.0	2.7
International	15%	11 - 15	14.0	13.4
Real Estate	10%	3 - 5	4.0	3.3
Alternative Investments*	10%	1 - 3	2.0	1.7
Additional Categories	10%	1 - 4	<u>2.0</u>	<u>2.5</u>
<b>TOTAL</b>			<b>100.0%</b>	<b>100.0%</b>
This weighting reflects cash with manager in the manager's asset class.				
* Alternative Investments includes Private Equity, Timberland, Venture Capital and Infrastructure investments.				

## PORTFOLIO RETURNS

For the fiscal year, the System's portfolio generated a total return of 13.1%, matching the return of the benchmark Policy Index. Domestic equities returned 15.1% versus 15.6% for the Standard & Poor's 1500 Index, while international equities returned 12.5% versus 10.9% for the MSCI All Country World (Ex-US) Index. Fixed income investments outperformed, returning 11.7% versus 9.7% for the Barclays Government/Credit Index. Other asset classes such as alternative investments, though growing, were not large enough to substantially impact total System performance in the fiscal year.

The table below details historical performance for the System and its component asset classes for the period ended June 30, 2010. The System's domestic equity and fixed income components have regularly exceeded the returns of their benchmarks over long periods of time. International equities, with a shorter history in the System, have outperformed their benchmark. Other asset classes are expected to generate a more significant portion of the System's total return in the future. The System's returns were generated by the Rogers Casey performance reporting system using a time-weighted rate of return calculation based upon the modified Dietz methodology.

	<u>1 Yr.<sup>(2)</sup></u>	<u>3 Yr.<sup>(2)</sup></u>	<u>5 Yr.<sup>(2)</sup></u>	<u>10 Yr.<sup>(2)</sup></u>	<u>20 Yr.<sup>(2)</sup></u>
<b>Total Fund</b>					
KTRS	13.1	-2.9	2.2	2.7	7.2
Policy Index <sup>(1)</sup>	13.1	-	-	-	-
<b>Equities</b>					
Domestic Equities	15.1	-9.1	-0.4	-0.2	8.3
S & P Blended Index <sup>(3)</sup>	15.6	-9.5	-0.6	-1.5	7.7
International Equities	12.5	-10.2	-	-	-
MSCI AC World (Ex US)	10.9	-10.3	-	-	-
Total Equities	14.4	-9.2	-0.4	-0.2	8.3
<b>Fixed Income</b>					
Total Fixed Income	11.7	8.7	6.2	7.0	7.5
Barclays Govt/Credit Index	9.7	7.4	5.3	6.5	7.2
<b>Real Estate</b>					
Real Estate Equity	-16.8	-	-	-	-
NCREIF ODCE	-6.0	-	-	-	-
Triple Net Lease Real Estate	8.8	8.8	9.2	9.0	8.8
CPI plus 2%	3.1	3.6	4.3	4.4	4.6
<b>Alternative Investments</b>					
Private Equity <sup>(4)</sup>	17.1	1.6	-	-	-
Timberland	-4.2	-	-	-	-
NCREIF Timberland Index	-3.5	-	-	-	-
<b>Cash</b>					
Cash (Unallocated)	0.2	1.8	3.5	3.0	4.3
<b>Additional Categories<sup>(5)</sup></b>					
High Yield Bond Fund	-	-	-	-	-
Public-Private Investments	-	-	-	-	-

(1) Prior to July 1, 2008, KTRS did not benchmark overall fund performance. Effective July 1, 2008, the Board of Trustees approved a Policy Index which represents the returns of appropriate benchmarks for the various asset classes weighted by the mid-point of the strategic range for the current fiscal year.

(2) Annualized.

(3) Total Domestic Equity is benchmarked to a S & P Blended Index. Total domestic equity was benchmarked to the S & P 500 through the fiscal year ending 6/30/2007. As of 7/1/2007, domestic equity is benchmarked to the S & P 1500 Index since the System's domestic stock mix is most comparable to this index.

(4) For a period of five years private equity will be benchmarked against their own returns. The primary reason for this is that these investments have a minimum investment horizon of ten years and there is no market benchmark that would be expected to track these types of assets in their early years. Beginning five years after the commitment date, investments in this class shall be benchmarked versus the S & P 500 plus 3%, which is the System's long-term expected return for this asset class.

(5) The investments in the Additional Categories asset class have not been in existence for a complete fiscal year; therefore, no yearly returns are available. The investments in this class shall be benchmarked versus the Merrill Lynch High Yield Master II.

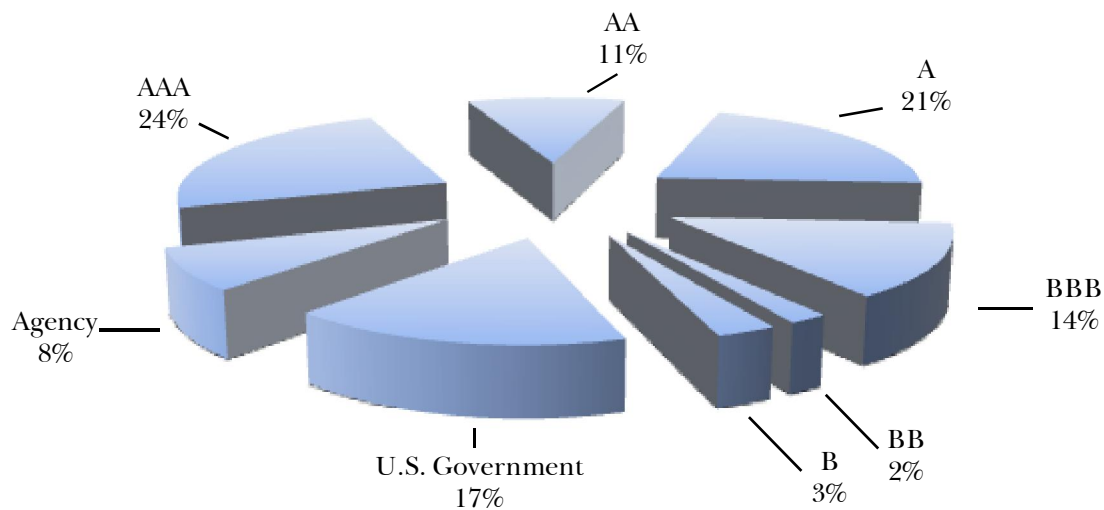


### FIXED INCOME INVESTMENTS

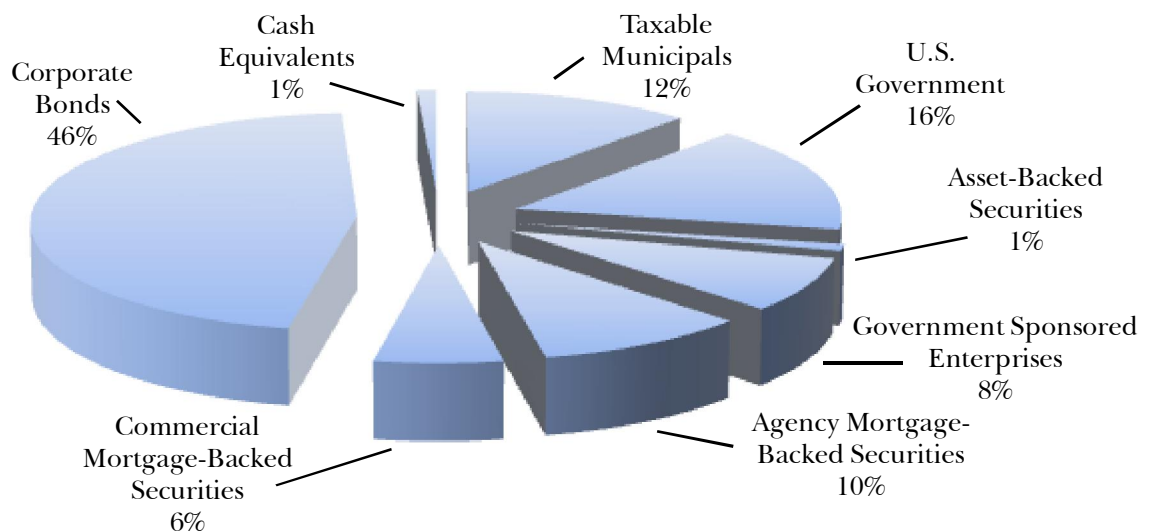
As of June 30, 2010, the System had approximately \$4.17 billion in fixed income assets, including \$232.7 million in high-yield bonds. The System's investment policy established by administrative regulation requires that all fixed income investments be rated investment grade at the time of purchase and that the fixed income portfolios as a whole maintain an average rating equal to at least "AA" by one of the major rating agencies. The regulation also allows that up to 10% of System assets may be invested in additional categories of investments approved by the Board of Trustees. Having been approved by the Board as an additional category of investments, a high-yield bond portfolio was funded in the fiscal year with an initial allotment of \$225 million.

Excluding the high-yield portfolio, fixed income investments maintained the required "AA" average rating as of June 30, 2010. The credit quality distribution, including the high-yield portfolio, is illustrated below. Also illustrated below is the distribution of fixed income assets by sector, again including the high-yield portfolio.

#### FIXED INCOME QUALITY DISTRIBUTION



#### FIXED INCOME SECTOR DISTRIBUTION



### FIXED INCOME MARKET OVERVIEW

The functioning of credit markets healed surprisingly quickly over the fiscal year, even as it became increasingly clear that healing the economy's woes was a long-term proposition. Bond market sectors that became dysfunctional and plunged in value during the financial crisis and recession recovered impressively. The Barclays High Yield Index returned 26.77% for the fiscal year, while investment grade commercial mortgage-backed securities returned 30.12%. Investment grade corporate bonds returned 15.92% while safe havens such as agency mortgage-backed securities returned 7.47% and U.S. Treasuries returned 6.67%. The Barclays Government/Credit Index returned 9.65%.

The Federal Reserve kept short-term rates near zero throughout the fiscal year. Yields on risk-free Treasuries trended up from the late fall of 2009 to the early spring of 2010 as the economy rebounded from the depths of the recession. Treasury yields then started a renewed plunge downward in the spring as it became clear that the U.S. recovery was weakening and a sovereign debt crisis in Europe hit the headlines. Over the fiscal year, the yield on the two-year Treasury declined from 1.11% to 0.60% and the yield on the thirty-year Treasury declined from 4.33% to 3.89%.

At the end of the fiscal year, the economic landscape was looking decidedly dismal. Inflation-adjusted GDP growth had slowed from a 5.0% annual rate in the quarter ended December 31, to 3.7% in the March 31 quarter, to a mere 1.7% rate in the June 30 quarter. With the economy too anemic to generate significant job creation, the unemployment rate remained at 9.5%. The housing market, so central to the financial crisis, remained deeply distressed. Mortgage delinquency and foreclosure rates seemed to have peaked, but were still near record levels, and the Case-Shiller Index of home prices remained over 28% below its peak with a massive inventory of unsold homes still overhanging the market. With confidence weak and credit availability still limited, consumers were in a deleveraging mode. There were fiscal problems at all levels of government. Consumer price inflation, excluding food and energy, was running at 0.9% annually. There was no prospect of a reversal of monetary policy in the foreseeable future.

The System moved to take advantage of opportunities in still-dislocated sectors of the credit markets during the fiscal year. A \$225 million initial allotment was made to a high-yield bond portfolio. To take advantage of dislocations in the residential and commercial mortgage-backed securities markets, a total commitment of \$120 million was made to two fund managers participating in the U.S. Treasury's Public-Private Investment Program (PPIP). As required by administrative regulation, both the high-yield bond portfolio and the PPIP commitments were approved by the Board as "additional categories of investments." Other than Board-approved "additional categories," fixed income investments are governed by conservative guidelines in administrative regulation. In those core portfolios, changes were made, such as increasing exposure to high quality commercial mortgage-backed securities, to capture superior relative value. By the end of the fiscal year, previously undervalued sectors had largely recovered and opportunities to pick up relative value had diminished.

As of mid-2010, bond yields were at historic lows, the economy was weak and uncertain, and there appeared no near-term prospect of a change in Federal Reserve policy of near zero short-term interest rates. Return prospects on core fixed income were clearly unappealing. While conditions seemed to portend an extended period of ultra-low yields, the risks of market losses were high in the event of rising rates or credit deterioration. Going forward in this environment, the focus was on risk control and fixed income's role in providing diversification and liquidity to the overall portfolio.

### EQUITY INVESTMENTS

As of June 30, 2010 the System's public equity investments had a market value of \$7.6 billion, representing 59.7% of total assets. Strong equity returns over the first nine months of the year prompted several rebalancing sales to reduce equity exposure back to target levels. The System divides its public equity investments into two broad categories: domestic and international.

The domestic portfolio had a market value of \$5.9 billion as of June 30, representing 46.3% of total assets. The benchmark for the domestic portfolio is the S&P 1500. The S&P 1500 is made up of three well known component indices based upon capitalization: the S&P 500 large cap, S&P 400 mid cap, and the small cap S&P 600. The System's domestic equity holdings are comprised of eleven portfolios. Three of the portfolios are internal passively managed portfolios benchmarked to the S&P 500, S&P 400, and S&P 600. The other eight portfolios are managed externally with each representing a specific strategy and measured against an appropriate benchmark. The collective array of portfolios provides diversification by capitalization, manager, style, and strategy.

The market value of international equity holdings as of June 30, 2010 was \$1.7 billion representing 13.4% of total assets. The benchmark for international equities is the Morgan Stanley Capital International All Country World Index ex US (MSCI ACWI-exUS), which represents the markets of 24 developed countries and 21 emerging markets countries. Four external managers manage the System's international equities. During the fiscal year, international equities increased as a percent of total assets despite the decline in international markets as the System continued to increase its exposure to international equities. The System plans to continue increasing the international equity exposure during the coming fiscal year.

### **EQUITY MARKET OVERVIEW**

For the fiscal year 2010, equity markets staged a rebound as they recovered from the financial crisis. The Morgan Stanley Capital International (MSCI) World Index advanced 10.8%. Returns of domestic stocks, as measured by the Standard & Poor's 1500 Index, were 15.6%. The MSCI EAFE, which measures the returns of international developed markets, had a return of 6.4%. This was the second straight year that domestic equity returns outperformed those of the MSCI EAFE. Emerging market returns topped those of developed markets as the MSCI Emerging Markets Index advanced 23.5%.

Domestic stocks enjoyed strong returns for the first nine months of the fiscal year as the S&P 1500 rose 30.1%. Several events occurred late in the year which shook investor confidence and resulted in a decline of 11.2% over the last quarter. For the first nine months, the market continued to ride the rebound from the March 2009 lows, believing that the worst of the recession was over and that economic activity and corporate profits would improve. As the year progressed, it became apparent that the recovery would not be as robust or as certain as was believed earlier in the year. Real GDP growth, which registered 5.0% for the December 31 quarter, slowed to 1.7% for the June 30, 2010 quarter. Housing prices showed only modest improvement from their mid 2009 lows, and the unemployment rate ended the year at 9.5%, the same level as when the year began.

The past year was marked by several events which led to a decline in investor confidence and a late year stock selloff. Fears of sovereign debt default of several European countries had been simmering for months and reached a flashpoint when Standard & Poor's downgraded Greece's credit rating to junk status in April. Although Greece represents only about 2% of the European Union's GDP, many feared that the crisis could spread to other European countries such as Spain, Portugal, and Ireland, which, like Greece, have debt levels which are a large percentage of their GDP. Although the European Union agreed to provide financial relief to struggling countries, the damage to confidence had already occurred. Another event undermining investor confidence was dubbed the "flash crash" and occurred late in the afternoon of May 6, 2010. Within minutes the Dow Jones Industrial Average fell hundreds of points to an intra-day decline of almost 1,000 points before rebounding almost as fast to end the day down several hundred points. Many stocks traded at unexplainable levels, forcing the exchange to cancel many trades. The inability of the regulators to explain the event only added to investor anxiety. On April 20, 2010, a rig contracted by BP in the Gulf of Mexico exploded and sank, resulting in the largest domestic oil spill ever. The continual media coverage of the event and the resulting financial and ecological damage had a negative impact on consumer confidence. The accident had a direct effect upon energy stocks, and the energy sector was the worst performing sector for the second year in a row.

As was the case in 2009, the role government played with regard to regulation, stimulus, and monetary policy was central to investor confidence. Following the financial crisis and subsequent fallout, much attention was focused on Washington and what new regulations would be crafted regarding financial institutions and the amount of risk they could bear. "Too big to fail", the Madoff fraud, and the "flash crash" were hot topics on the regulatory agenda. While the government was winding down its Troubled Asset Relief Program (TARP), it still found itself in an ownership or creditor relationship with private companies. The government still controlled, or owned large stakes in, Fannie Mae, Freddie Mac, American International Group, Citigroup, Chrysler, and General Motors. On the stimulus front, the administration has made many efforts to boost the economy and create jobs with programs such as the American Recovery and Reinvestment Act of 2009, along with stimulus programs aimed at home ownership and auto sales. The Federal Reserve has continued its policy of keeping rates low to help stimulate the economy. With rates low, the Federal Reserve has also resorted to quantitative easing, whereby it increases the supply of money by buying securities held by banks and other financial institutions. The role of government with regard to regulation, stimulus, and monetary policy will play a central role in the performance of the equity markets during the coming year.

### REAL ESTATE

The System's real estate investments had a market value of \$419.6 million as of June 30, 2010, representing 3.3% of total assets. The System's investments in real estate are intended to provide attractive long-term returns, generate reliable cash flow, and provide diversification, thereby reducing the volatility of the overall investment portfolio.

The System's real estate exposure is currently provided through two portfolios. The System maintains an internally managed portfolio of directly owned properties under long-term lease agreements with high credit quality tenants. The System is also invested in a commingled real estate fund (PRISA FUND), which is managed by Prudential Real Estate Investors. This fund is a core real estate equity fund which invests primarily in existing income-producing properties with strong cash flow and the potential for capital appreciation. The fund is diversified across several property types including office, retail, industrial, apartment, self-storage, and hotel.

### REAL ESTATE OVERVIEW

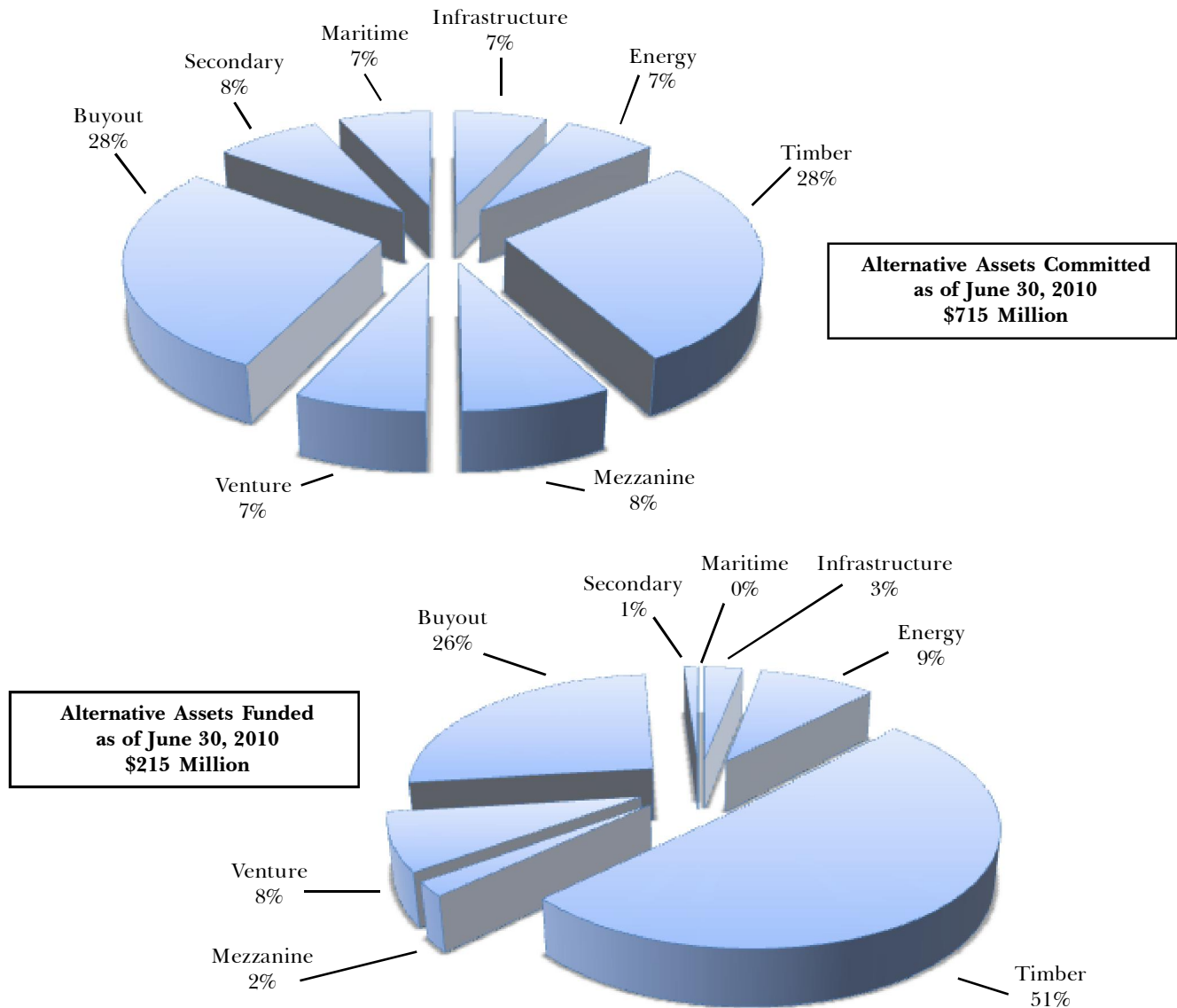
Real estate fundamentals improved in the second half of the fiscal year as commercial real estate investors sensed that property values were at or near a cyclical bottom. Both equity and debt capital flows into real estate picked up as occupancy rates and rents started to improve in select property types and markets. While broad market improvement in rents and occupancy will remain sluggish until a sustained improvement in job growth occurs, there were clearly opportunities for investors to take advantage of buying opportunities in a depressed market.

We expect the 2010-2011 fiscal year to be one of transition as fund managers continue to deleverage and refinance existing properties. While the contraction in demand appears to be largely over, new supply is expected to remain subdued for several more years. Opportunistic investments will be abundant for those investors who have available capital to provide financing at profitable rates and who are in a position to purchase properties at attractive levels from distressed sellers.



### ALTERNATIVE ASSETS

As of June 30, 2010, the System had committed \$715 million to alternative investments and had funded \$215 million of those commitments. The percentage of the System's portfolio in alternative assets was 1.7%. The System's current alternative asset portfolio consists of private equity investments and timberland.



### PRIVATE EQUITY

The System has exposure to venture, buyout, infrastructure, energy, and mezzanine via participation in limited partnerships as well as investments in funds of funds. The System is in the early stages of its private equity investment program, which it intends to grow with a disciplined plan of commitments over the next several years. The System looks to diversify its private equity portfolio by firm, country, strategy, and vintage year. The System will achieve vintage year diversification by building out the portfolio with disciplined levels of commitments over time. The System's commitment to any given partnership shall not exceed 20% of the partnership's total commitments.

The Board and staff understand that private equity (along with many other forms of alternative assets) are illiquid and have a long-term holding period. When added to a portfolio with other publicly traded assets, this asset class can help to diversify and reduce risk for the System's overall portfolio while enhancing returns. Private equity returns for the first several years of a partnership's life are routinely negative due to the J-curve effect. Positive returns are typically realized only several years into a partnership's existence.

### PRIVATE EQUITY MARKET OVERVIEW

The private equity market showed notable signs of improvement as the fiscal year progressed after experiencing a near standstill during the credit crisis. While nowhere near pre-crisis levels, the ability of fund managers to raise investment capital has clearly seen an uptick. An overall improvement in the stock market has led to increased activity in the IPO market, providing more opportunities for fund managers to exit existing investments. As the financial markets continue to heal, capital calls will pick up as more investment opportunities present themselves, although distributions will probably remain subdued over the next year.

Large buyout funds have been largely out of favor since the beginning of the financial crisis due to a lack of favorable financing. However, attractive opportunities were ample in the mezzanine and secondary sectors during the past year. Looking forward, it is anticipated that solid investment opportunities will be available in the distressed credit sector of the market, primarily in the middle market space. The financial crisis currently unfolding in the Eurozone should provide a favorable environment to invest in distressed credit markets in Europe

### TIMBERLAND

In addition to private equity, the System has invested in timberland in the alternative asset class. As of June 30, 2010 the System owns approximately 73,000 acres of timberland outright and has a 7.15% interest in a commingled fund that holds 97,938 acres of timberland. Timberland is, by nature, a long term investment as our anticipated time horizon in this asset category is generally a minimum of ten to fifteen years. Timberland provides valuable diversification, current income, and a hedge against inflation. Due to the low correlation of returns with other asset classes, timberland investments should lower the overall volatility of the System's portfolio. Timberland should earn real returns comparable to traditional equity investments with volatility between equities and fixed income over the long-term.

The System diversifies its timberland investments by geography, species of trees, and maturity of timber stands. Investment returns from timberland are primarily driven from net cash flow generated from the sale of trees (referred to as stumpage sales) and capital appreciation from the biological growth of the trees. Both of these return factors depend to some degree upon the direction of the forest commodity prices (paper goods and lumber products). There can also be gains from the timely sale of timberland from the conversion of timberland into higher and better uses, such as vacation property sales.

### TIMBERLAND MARKET OVERVIEW

The tepid pace of recovery in both the U.S. housing market and the overall economy continues to adversely affect U.S. timber markets. A rebound in the housing market remains constrained by record foreclosures, tight credit conditions, and stubbornly high unemployment. However, going into next fiscal year many industry experts are cautiously optimistic about a gradual recovery in the demand for lumber. This optimism is based on an expected increase in U.S. construction spending and an anticipated uptick in home improvement and remodeling activity. Furthermore, as the global economy recovers, we should see a pickup in timber exports to countries such as China and South Korea.

<p align="center"><b>PORTFOLIOS</b>  <b>MARKET VALUES **</b>  <b>June 30, 2010</b></p>
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**Internally Managed****Cash Equivalents**

Cash Collections Fund (Unallocated)	218,429,317
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**Fixed Income\***

Broad Market Bond Fund	1,029,183,758
Long Term Bond Fund	586,992,599
Intermediate Bond Fund	470,484,165
Internal Bond Fund	261,006,375
Life Insurance Trust	86,455,572
Tax Shelter Fund	448,085

**Equity**

S & P 500 Stock Index Fund (Large Cap)	2,057,546,867
S & P 400 Stock Index Fund (Mid Cap)	317,995,096
S & P 600 Stock Index Fund (Small Cap)	221,369,425

**Real Estate**

Internally Managed Fund	<u>391,439,237</u>
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**Subtotal**

<b><u>5,641,350,496 ***</u></b>
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**Externally Managed****Fixed Income**

Galliard Capital Management	769,966,491
Ft. Washington Broad Market	728,479,433

**Domestic Equity**

Todd - Veredus (Large Cap Core)	1,040,553,447
UBS (Large Cap Value)	752,827,093
GE Asset Management (Large Cap Growth)	550,145,051
Wellington (Large Cap Core)	393,820,288
Wellington (Mid Cap Core)	236,813,283
Wellington (Small Cap Core)	117,881,282
Todd - Veredus Opportunity Fund	97,236,017
UBS (130/30)	85,813,378

**International Equity**

Todd - Veredus International	522,366,377
UBS International	514,470,507
Baillie Gifford EAFE Alpha	346,703,154
Baring Focused International Equity	319,619,142

**Real Estate**

Prudential PRISA Fund	28,174,434
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*continued ...*

# KENTUCKY TEACHERS' RETIREMENT SYSTEM

## PORTFOLIOS continued ... JUNE 30, 2010

### Alternative Investments

Molpus Woodlands Group Lake Superior Timberlands LLC	89,260,480
Hancock Bluegrass LLC - Oregon	19,321,729
Riverstone/Carlyle E & P Fund IV	22,564,831
KKR & Co European Fund III	21,836,749
KKR & Co Fund 2006	18,463,171
Ft. Washington Fund VI	12,364,325
Chrysalis Venture Fund III	10,195,122
Alinda Infrastructure Fund II	9,496,506
Ft. Washington Fund V	8,422,784
Landmark Equity Partners Fund XIV	2,702,755
CapitalSouth Partners Fund III	1,718,002
Oaktree Mezzanine Fund III	1,400,000
Parish Capital Fund III	1,136,304
J. P. Morgan Maritime Fund	320,034
Lexington Capital Partners Fund VII	137,228

### Additional Categories

Fort Washington High Yield Bond Fund	232,651,457
Marathon Legacy Securities PPIP	40,598,924
AG GECC PPIF, LP	39,696,703

### Subtotal

**7,037,156,481**

### Total Assets

**12,678,506,977**

\* Excludes purchased interest of \$1,450,327 as June 30, 2010

\*\* Detailed information concerning these market values of all KTRS investments is available upon request.

\*\*\* As of June 30, 2010, the Scholarship Fund is no longer reported in the pension fund Investment portfolio. The value of this fund at June 30, 2010 was \$482,153.

### Investment Summary Fair Market Value – Total Funds June 30, 2010

Type of Investment	Fair Value 07/01/09	Acquisitions	Appreciation (Depreciation)	Sales Redemptions, Maturities & Paydowns	Fair Value 06/30/10
Cash Equivalents	\$ 256,900,000	\$ 53,043,964,900	\$ -	\$ 52,993,486,600	\$ 307,378,300
Fixed Income	3,785,836,400	2,233,431,200	240,528,800	2,132,923,000	4,126,873,400
Equities	7,086,247,000	2,128,364,300	929,219,800	2,616,892,600	7,526,938,500
Real Estate	425,746,100	2,390,800	(8,523,200)	-	419,613,700
Alternative	177,330,400	129,673,700	9,203,400	16,571,900	299,635,600
<b>TOTAL</b>	<b>\$ 11,732,059,900</b>	<b>\$ 57,537,824,900</b>	<b>\$ 1,170,428,800</b>	<b>\$ 57,759,874,100</b>	<b>\$ 12,680,439,500</b>

Year Ended June 30, 2010



**Contracted Investment  
Management Expenses  
Fiscal Year 2009-10  
(in thousands of dollars)**

<u>Investment Manager Fees</u>	<u>Assets Under Management</u>	<u>Expense</u>	<u>Basis Points (1)</u>
Equity Managers	\$ 4,978,249	\$ 9,955	
Fixed Income Managers	1,731,097	845	
Real Estate	28,174	328	
Alternative Investments (2)	299,636	5,618	
Total	\$ 7,037,156	\$ 16,746	23.8
 <u>Other Investment Services</u>			
Custodian Fees	\$ 12,678,507	\$ 502	0.4
Consultant Fees		364	
Legal & Research		50	
Subscriptions/Services		544	
Total		1,460	
<b>Grand Total</b>		<b>\$ 18,206</b>	<b>14.4</b>

1 – One basis point is one hundredth of one percent or the equivalent of .0001.

2 – Private equity fees are either withheld from the Fund operations or paid by direct disbursement, depending on contract terms.

# KENTUCKY TEACHERS' RETIREMENT SYSTEM

## Transaction Commissions Fiscal Year 2009-10

COMPANIES	SHARES TRADED	COMMISSIONS	COMMISSION PER SHARE
Barclays	1,826,271	\$ 63,006.25	0.0345
Bass / Baypoint Trading	42,300	1,692.00	0.0400
BB & T Capital Markets	74,300	2,972.00	0.0400
Bear Stearns & Co., Inc.	12,200	488.00	0.0400
Blair, William & Co	209,880	8,147.20	0.0388
BMO Capital Markets	63,900	2,556.00	0.0400
BNY ConvergeEX Group	1,313,914	40,327.01	0.0307
Boenning & Scattergood	4,000	90.00	0.0225
BTIG	246,000	10,403.00	0.0423
Canacord Adams	69,700	2,788.00	0.0400
Cantor Fitzgerald & Co	62,600	2,406.00	0.0384
Chapdelaine Institutional	10,340	413.60	0.0400
CIBC Oppenheimer Worldmarket	87,800	3,512.00	0.0400
Citigroup Global	1,006,706	30,070.03	0.0299
Collins Stewart LLC	6,900	288.00	0.0417
Cowen & Co	306,690	11,517.60	0.0376
Credit Research & Trading LLC	41,700	1,668.00	0.0400
Credit Suisse Sec. LLC	3,410,840	116,603.20	0.0342
Crowell Weedon & Co	82,100	3,067.00	0.0374
CRT Capital LLC	14,100	564.00	0.0400
CSI US Institutional (Calyon)	43,200	1,728.00	0.0400
Cuttone & Co Inc	6,200	139.50	0.0225
D A Davidson & Co	47,400	1,896.00	0.0400
Dahlman Rose & Co LLC	14,600	584.00	0.0400
Deutsche Bank	618,650	28,928.75	0.0468
Dowling & Partners	60,200	2,408.00	0.0400
First Kentucky Securities Corp	2,421,500	80,182.00	0.0331
Fox Pitt Kelton Inc	16,200	648.00	0.0400
Freidman Billings	183,100	7,324.00	0.0400
FTN Financial	3,600	144.00	0.0400
Goldman Sachs	3,208,992	105,126.88	0.0328
Heflin & Co	73,200	2,928.00	0.0400
Hudson Securities	1,300	52.00	0.0400
ICAP Corporates LLC	9,600	384.00	0.0400
Instinet	9,053	103.03	0.0114
Investment Tech Grp Transition	10,118,787	88,092.45	0.0087
Investment Technology Grp	56,588,062	718,544.07	0.0127
ISI Group	3,401,610	110,749.52	0.0326
J.J.B. Hilliard, W.L. Lyons	3,157,502	103,835.07	0.0329
Janney Montgomery Scott Inc	72,300	2,892.00	0.0400
Jefferies & Co.	556,680	19,183.60	0.0345
JMP Securities	108,800	4,422.00	0.0406
Jones & Associates	2,500	100.00	0.0400
JP Morgan & Chase	1,098,385	26,557.23	0.0242
Keefe Bruyette & Woods	43,366	7,731.89	0.1783
Kellogg Partners Inst Svs	1,300	29.25	0.0225
Keybanc Capital	18,200	3,227.00	0.1773
Knight Equity Markets	251,200	9,797.00	0.0390
LaBranche Financial Svs LLC	46,400	1,856.00	0.0400
Lazard Freres & Co.	3,038,630	102,561.20	0.0338
Leerink Swann & Co.	54,800	2,215.00	0.0404
Legent Clearing Corp	14,000	560.00	0.0400
Lexington Investment Co.	1,271,570	39,786.60	0.0313
Liquidnet Inc	7,180,595	102,243.76	0.0142
Longbow Securities LLC	3,800	152.00	0.0400
MacQuarie Securities Inc	65,200	2,678.00	0.0411

Year Ended June 30, 2010

*Transaction Commissions continued . . .*

COMPANIES	SHARES TRADED	COMMISSIONS	COMMISSION PER SHARE
Melvin Securities Inc	4,400	44.00	0.0100
Merrill Lynch	10,913,793	204,129.33	0.0187
Miller Tabak & Co. LLC	40,200	1,608.00	0.0400
Morgan Keegan	1,919,200	63,000.50	0.0328
Morgan Stanley Smith Barney-Hunt	3,074,524	100,980.84	0.0328
Morgan Stanley Smith Barney-Louv	1,876,300	61,692.00	0.0329
Morgan Stanley Smith Barney-NKY	3,049,400	101,229.00	0.0332
Morgan Stanley	2,417,049	51,930.77	0.0215
Murphy & Durieu	27,400	616.50	0.0225
Needham	38,700	1,548.00	0.0400
Nomura Securities Intrntl Inc	10,800	-	0.0000
Nova Capital Markets LLC	32,900	1,316.00	0.0400
OTA Limited Partners	68,800	2,752.00	0.0400
Pali Capital Inc.	45,500	1,820.00	0.0400
Pershing LLC	125,850	3,363.63	0.0267
Pickering Energy Partners Inc.	6,800	272.00	0.0400
Pipeline Trading	65,000	650.00	0.0100
Piper Jaffray	115,100	4,398.00	0.0382
Pulse Trading	448,490	9,174.53	0.0205
R W Baird	171,600	5,761.00	0.0336
Raymond James & Assoc	5,375,858	175,434.86	0.0326
RBC Capital Markets	207,300	8,218.00	0.0396
Ross Sinclair & Assoc	1,219,500	40,110.00	0.0329
Sandler O'Neill	28,400	7,350.60	0.2588
Sanford C Bernstein	856,527	13,043.27	0.0152
Simmons & Co	65,750	2,630.00	0.0400
SJ Levinson & Sons LLC	18,200	728.00	0.0400
Soleil Securities Co	17,600	704.00	0.0400
State Street Global	12,500	375.00	0.0300
Stephens Inc.	24,300	3,819.00	0.1572
Sterne, Agee & Leach	191,300	8,689.00	0.0454
Stifel, Nicolaus & Co	2,649,300	88,755.00	0.0335
Stifel, Nicolaus & Co-Louisville	1,270,600	43,846.00	0.0345
Suntrust Robinson	24,400	976.00	0.0400
Susquehanna Brokerage	351,326	10,473.50	0.0298
The Benchmark Company LLC	14,200	568.00	0.0400
Think Equity Partners	8,600	344.00	0.0400
Thomas Weisel Partners	63,900	1,484.00	0.0232
UBS/Paine Webber Securities	1,939,009	37,000.98	0.0191
UBS/Paine Webber-Louisville	5,107,300	162,385.49	0.0318
Wachovia / First Clearing Corp	7,100	284.00	0.0400
Weeden & Co	3,270,600	108,422.00	0.0332
Wells Fargo Securities, LLC	124,000	5,120.00	0.0413
White Cap Trading LLC	4,400	99.00	0.0225
WUB Capital Group Inc	42,000	1,680.00	0.0400
<b>GRAND TOTAL</b>	<b>150,048,499</b>	<b>\$ 3,221,194.49</b>	<b>0.0215</b>

The over-the-counter commission rate on medium to large capitalization stocks is assumed to be \$.03 per share. The acquisition of initial public offerings (IPOs) represented a portion of small capitalization stock purchases. IPOs usually have a high commission rate. However, the security issuers and not the investors pay the commissions. In 2009-10, the System bought small capitalization IPOs that generated \$43,352 in commissions. Although these commissions were not paid by the Retirement System, they resulted from the System's investment activities and are included in the total commissions of \$3,221,194. Typical stock transactions occur at lower commission rates than IPO transactions, frequently \$.03 per share or less. Investment companies usually provide investment research for brokerage clients. On occasion, investment companies direct third party research to active clients. The Retirement System received third party research through BNY Convergenx. Trading commissions of \$30,399 were associated with third party research obligations. The primary research providers were: Bloomberg, Interactive Data, Rogers Casey, RiskMetrics Group, QED Financial Systems, Standard & Poor's, and Thomson Financial.

**Ten Largest Stock Holdings Ranked (1) (2)  
by Market Value  
June 30, 2010**

<u>Rank</u>	<u>Name</u>	<u>Market Value</u>	<u>Percentage of Equities</u>
1	Microsoft Corp	115,166,684	1.839
2	Exxon Mobil Corp	106,591,180	1.702
3	Apple Inc	103,743,549	1.657
4	Pepsico Inc	93,166,281	1.488
5	A T & T Inc	82,812,070	1.322
6	Johnson & Johnson	81,913,503	1.308
7	Cisco Systems Inc	76,585,114	1.223
8	Qualcomm Inc	69,987,163	1.117
9	Hewlett Packard	65,526,656	1.046
10	Chevron Corp	60,874,967	0.972

**Top Ten Fixed Income Holdings (2)  
by Market Value  
June 30, 2010**

<u>Rank</u>	<u>Description</u>	<u>Maturity</u>	<u>Coupon</u>	<u>Par</u>	<u>Market Value</u>	<u>Percent of Fixed Income</u>
1	U S Treasury Bonds	8/15/2023	6.250	61,500,000.00	79,719,375.00	2.048
2	U S Treasury Notes	5/15/2020	3.500	75,640,000.00	79,161,798.40	2.033
3	U S Treasury Notes	6/30/2016	3.250	40,000,000.00	42,422,000.00	1.090
4	U S Treasury TIPS	4/15/2012	2.000	37,000,000.00	41,177,296.30	1.058
5	U S Treasury Notes	3/31/2015	2.500	38,000,000.00	39,377,500.00	1.011
6	FNMA Notes	1/15/2030	7.130	25,000,000.00	34,031,250.00	0.874
7	U S Treasury Bonds	8/15/2029	6.130	22,000,000.00	29,225,680.00	0.751
8	U S Treasury TIPS	1/15/2029	2.500	25,000,000.00	28,689,475.75	0.737
9	CMO FHR 3095 JE	7/15/2031	5.500	23,604,000.00	24,862,109.72	0.639
10	U S Treasury Notes	11/15/2013	4.250	22,000,000.00	24,261,820.00	0.623

(1) Includes only actively managed separate accounts.

(2) Detailed information concerning these values along with book values and cost values of all KTRS investments is available upon request.

### **PROXY VOTING AND CORPORATE BEHAVIOR**

The System regularly votes proxy statements associated with its equity ownership. The positions assumed by the System are intended to represent the financial interests of the membership. The Board of Trustees has adopted a policy that directs the staff not to subjugate the financial concerns of the System to social or political protests. At the same time, the System expects the companies in which it acquires stock to be solid corporate citizens that abide by federal, state, and local laws. The Board has adopted the following position on corporate behavior:

The Board's stated fiduciary duty is to obtain the highest return for the Fund commensurate with acceptable levels of risk. This implies that non-financial considerations cannot take precedence to pure risk/return considerations in the evaluation of investment decisions. However, action taken by the Fund as a shareowner can be instrumental in encouraging action as a responsible corporate citizen by the companies in which the Fund has invested.

The Board expects the managements of the companies whose equity securities are held in the Fund's portfolio to conduct themselves with propriety and with a view toward social considerations. A level of performance above minimum adherence to the law is generally expected. If any improper practices come into being, the Board expects corporate management to move decisively to eliminate them and effect adequate controls to prevent recurrence.

On the other hand, the Board does not intend to supplant the duties which are the responsibility of federal or state regulatory agencies, such as the Equal Employment Opportunity Commission, the Environmental Protection Agency, the Occupational Safety and Health Agency, the Nuclear Regulatory Commission, the Securities and Exchange Commission, and others which are covered by the laws of the United States Government or the State of Kentucky.

Should satisfaction of the Board's criteria by any company not be adequate, the Board will consider what action to take, which may include, but not be limited to, correspondence with the company, meetings with company officials, sponsoring of shareholder resolutions or, as a last resort, liquidation of the System's holdings in the company, if the sale is consistent with sound investment policy.

### **SECURITY LENDING**

The System operates a security lending program in which it temporarily lends securities to qualified agents in exchange for a net fee and high quality collateral. U.S. Government and agency securities and select stocks and bonds are the types of securities loaned. The System's sub-custodian, The Bank of New York Mellon, acts as lending agent in exchanging securities for collateral. The collateral, at the time of the loan, has a value of not less than 102% of the market value of the lent securities plus any accrued, unpaid distributions. The collateral consists of cash, marketable U.S. Government securities, and selected marketable U.S. Government agency securities approved by the System.

Cash collateral is invested in short term obligations fully guaranteed by the United States Government or select Government agencies and Government Repurchase Agreements with qualified agents. The System cannot pledge or sell collateral securities unless the borrower defaults. The lending agent also indemnifies the System from any financial loss associated with a borrower's default and collateral inadequacy. The weighted average maturity of cash collateral investments is typically two days. The System has no credit risk exposure to borrowers, since the amounts the System owes borrowers exceeds the amounts the borrowers owe the System.

Security lending programs can entail considerable interest rate risk and credit risk. The System has structured its program to minimize these two main categories of risk. The interest rate risk is managed, as mentioned above, by limiting the term of cash collateral investments to several days.

## KENTUCKY TEACHERS' RETIREMENT SYSTEM

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The credit risk is controlled by investing cash collateral in securities with qualities similar to the creditworthiness of lent securities.

### KENTUCKY INVESTMENTS

The System is ever-mindful of its impact on the Commonwealth's economy. For the fiscal year ended June 30, 2010, approximately \$1.2 billion in defined benefit pension payments were distributed to annuitants living in Kentucky. Approximately \$325 million of the System's investments directly impact the Commonwealth. These investments include: pools of single-family mortgages in Kentucky; financing for multi-family housing; bonds issued by public agencies of the Commonwealth and those of local municipalities; direct ownership of commercial real estate, and investments in the bonds of Kentucky-based corporations. This excludes hundreds of millions in equity investments in companies which have an impact on the Commonwealth's economy but receive earnings from world-wide operations. Fiduciary duty requires that investments be made solely for the benefit of the System's members and annuitants. Investments which benefit the Commonwealth's economy are made only when fully consistent with this fiduciary duty.

### PROFESSIONAL SERVICE PROVIDERS

#### **Investment Consultant**

Hewitt Ennis Knupp + Associates

#### **Investment Custodian/Subcustodian**

Farmers Bank & Capital Trust Company  
The Bank of New York Mellon

#### **Fixed Income Managers**

Galliard Capital Management  
Ft. Washington Investment Advisors

#### **Domestic Equity Managers**

Todd-Veredus Asset Management LLC  
UBS Global Asset Management  
Wellington Management Company  
GE Asset Management

#### **International Equity Managers**

Todd-Veredus Asset Management LLC  
UBS Global Asset Management  
Baring Asset Management, Inc.  
Baillie Gifford

#### **Real Estate Managers**

Prudential Real Estate Investors

#### **Alternative Investment Managers**

Molpus Woodlands Group  
Hancock Natural Resources Group  
Kohlberg Kravis Roberts & Co.  
Chrysalis Ventures  
Ft. Washington Private Equity Investors  
Alinda Capital Partners, LLC  
Riverstone Holdings, LLC  
CapitalSouth Partners  
Landmark Partners  
Lexington Partners  
Oaktree Capital Management  
Parish Capital Advisors, LLP  
Audax Group  
J.P. Morgan Asset Management  
Marathon Legacy Securities GP, LLC  
AG GECC PPIF GP, LLC

#### **Attorney**

Schottenstein, Zox & Dunn, Co.